United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75 4227

To be argued by
James B. Lewis

UNITED STATES COURT OF APPEALS

For the Second Circuit

ESTATE OF EDWIN C. WEISKOPF, Deceased,
ANNE K. WEISKOPF and SOLOMON LITT,
Executors, and ANNE K. WEISKOPF,
Surviving Wife,

Petitioners-Appellants,

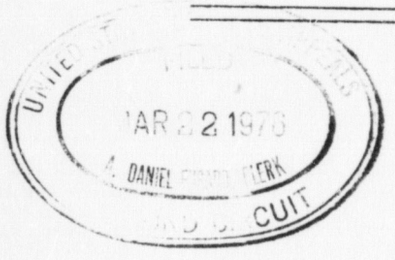
v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On Appeal from the United States Tax Court

REPLY BRIEF FOR PETITIONERS-APPELLANTS



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UNITED STATES COURT OF APPEALS
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ARGUMENT

I

Division of responsibilities between counsel.

Counsel for the two sets of petitioners-appellants have divided responsibilities in connection with reply briefs and oral argument as follows: (1) Counsel for Edwin C. Whitehead and Josephine Whitehead will brief and argue the issue of whether Ininco was a controlled foreign corporation

and will, therefore, respond to Part I of the brief for the respondent-appellee. (2) Counsel for Estate of Edwin C. Weiskopf, deceased, and Anne K. Weiskopf will brief and argue the remaining issues and will, therefore, respond to Parts II and III of the brief for the respondent-appellee.

II

The Commissioner erroneously argues that the sale of Intapco stock should be treated as the liquidation of Ininco.

Although the Commissioner repeatedly cites the recent Tax Court decisions in Gray and Owens,[1/] and says they are indistinguishable from the Tax Court's decision below (Appellee's Brief 39-41, 47), he does not successfully refute our argument that this line of Tax Court decisions is erroneous (Appellant's Brief 13-14). Gray, Owens and the instant case are on appeal to Courts of Appeals for three different Circuits. Unless and until those cases are affirmed, they do not represent solidified precedent. Congress has provided that decisions of the Tax Court are reviewable by the Courts of Appeals "in the same manner and

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1/ John D. Gray, 56 T.C. 1032 (1971), on appeal to 9th Cir.; E. Keith Owens, 64 T.C. 1 (1975), on appeal to 6th Cir.

to the same extent as decisions of the district courts in civil actions tried without a jury." Section 7482(a) of the Internal Revenue Code of 1954.

A sequence of three Tax Court decisions all of which are under review on appeal are entitled to no more weight than a single such decision. The fact that the Tax Court, because of its volume of decisions, rules on the same point more than once does not make its ruling more deserving of respect. If the Tax Court has strayed into error, it is unlikely that it will correct itself; the power and duty to reverse the error lie with the higher courts.

We deplore the position of the Tax Court below and in Gray and Owens because that position is (1) irreconcilable with earlier decisions of two Courts of Appeals [2/] discussed in our opening brief (Appellant's Brief 11-12) and (2) illogical and badly reasoned.

The Tax Court's inability to defend its position in the light of contrary precedent is easily illustrated. The taxpayer in Gray relied on brief on three cases in which holders of preferred stock had successfully converted ordinary income into capital gain by selling the preferred stock to

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2/ Granite Trust Company v. United States, 238 F.2d 670 (1st Cir. 1956); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945).

third parties just before and in anticipation of the redemption of the stock pursuant to call.[3] Stanley D. Beard, 4 T.C. 756 (1945); W. P. Hobby, 2 T.C. 980 (1943); Clara M. Tully Trust, 1 T.C. 611 (1943). In Beard, Hobby and Tully the Tax Court held for the taxpayers[4] on the ground that the taxpayer in each case "had an election as between two transactions, and bona fide he elected the one with less onerous tax consequences."[5] The Tax Court in Gray attempted to distinguish Beard, Hobby and Tully by saying: "In the cases cited by petitioners the questioned transactions were endowed with the economic reality that the ostensible sale [in this case] lacks."[6] By resort to the cliche "economic reality," the Tax Court simply refused to deal with the problem raised by counsel. The inadequacy of unreasoned reference to

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3/ The governing income tax statute in those cases was the Revenue Act of 1934, 48 Stat. 680. Section 115(c) of the Revenue Act of 1934 treated gain resulting from redemption of stock in partial or complete liquidation of the issuing corporation as ordinary income. However, section 117(a) of the Revenue Act of 1934 provided less onerous tax treatment for gain realized upon the sale or exchange of a capital asset held for more than one year. As a result, under the Revenue Act of 1934, sale of stock held for more than one year would produce a lower tax than redemption of the stock.

4/ 4 T.C. at 758; 2 T.C. at 985-986; 1 T.C. at 622-624.

5/ Stanley D. Beard, supra, 4 T.C. at 757-758.

6/ John D. Gray, supra, 56 T.C. at 1072.

"economic reality," "form" or "substance," and similar verbal talismans has been fully exposed by Louis Eisenstein:

> ". . . . Like those well-known words 'form' and 'substance,' the phrase is merely a verbal device for characterizing a particular result. It does not tell us why the result is correct or incorrect. In short, the phrase is a pleasurable narcotic which enables us to refrain from reason and analysis. The will to believe triumphs over the ability to think." 7/

The Tax Court's error below, in Owens, and in Gray is the same as its error in C. P. Chamberlin, 18 T.C. 164 (1952), rev'd and rem'd 207 F.2d 462 (6th Cir. 1953), cert. denied 347 U.S. 918 (1954). In Chamberlin, the Tax Court held that a preferred stock dividend distribution to common stockholders was taxable as ordinary income where the distributed preferred stock was sold for cash shortly after the distribution and, as a result, was reversed by the Court of Appeals for the Sixth Circuit.

Because Randolph Paul's brief for the taxpayer in Chamberlin so clearly exposes the unlawfulness of the Tax Court's derelict approach, we quote from it at length: 8/

7/ Eisenstein, Lingering Legends of Judicial Legislation, Proceedings of New York University Ninth Annual Institute on Federal Taxation, 1143, 1144 (1951).

8/ Paul, Brief for Petitioners in Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), cert. denied 347 U.S. 918 (1954).

"The issue in this case is easily stated. May the Treasury zealously disregard the network of rules so carefully devised by Congress, the courts, and itself because it would now write them differently if it were free to do so? The respondent tacitly assumes that he enjoys this sweeping power to determine fiscal policy. In making so generous an assumption on his own behalf he has failed to remember that one should not indulge in 'great thoughts about a tax problem unless the thoughts are firmly based on the controlling statute.' Griswold, Cases and Materials on Federal Taxation, p. 14 (2d ed. 1946). The Treasury 'can add nothing to income as defined by Congress,' though it may firmly feel that the definition could be improved. M.E. Blatt Co. v. United States, 305 U.S. 267, 279 (1938). The Treasury has 'only the responsibility of carrying out the Congressional mandate.' Helvering v. Wood, 309 U.S. 344, 347 (1940). We respectfully submit that the respondent has wandered well beyond the relevant statutes and disingenuously improvised a tax policy of his own.

". . . [W]e must confess our inability to follow the Tax Court's reasoning. The Tax Court states that 'not form, but the real substance of the transaction is controlling.' Then the Court observes that in terms of 'the real substance of the transaction, the facts show conclusively that the stock dividends were not in good faith for any bona fide corporate business purpose.' The preferred shares were issued 'primarily for the benefit of the common stockholders' and derived from tax considerations. . . .

* * *

"In attempting to make much of the petitioner's sale, as distinguished from the corporation's distribution, the Tax Court has forsaken all relevant statutes, regulations, and decisions. The Court seems to have forgotten that taxation 'is a matter of statutes and valid regulations, and what they mean.'

Jeffries v. Commissioner, [158 F.2d 225, 226 (5th Cir. 1946), cert. denied, 330 U.S. 843 (1947)]. Undoubtedly 'the judicial function in construing legislation is not a mechanical process from which judgment is excluded.' But it is also true that the judicial function is 'very different from the legislative function.' 'To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another.' Addison v. Holly Hill Fruit Products, Inc., 322 U.S. 607, 617-618 (1944). This admonition is peculiarly appropriate here. The Tax Court, in the fashion of the respondent, has called upon some brooding 'spirit' which is neither expressed nor restrained by any words which Congress has ever used. Since the opinion is untrammeled by any statute, it is vagrant and unconfined. Inevitably it leads into a quagmire of confusion where any intelligible principles of law quickly sink and disappear. Whatever rule the Tax Court's opinion may attempt to state is no rule at all.

* * *

"It is not difficult to isolate the source of the respondent's unusual confusion. Contrary to all settled principles, he is attempting to tax a shareholder's sale of a nontaxable stock dividend as if it were a corporate distribution of a taxable dividend. Nor is it more difficult to understand why the respondent has been tempted to fall into this elementary error. The respondent is plainly disturbed that a sale of nontaxable dividend shares enables a stockholder to pay a capital gains tax on proceeds which represent the stockholder's interest in accumulated earnings of the corporation. But any sale of stock in a prosperous corporation has the same effect, whether the stock consists of original shares or dividend shares, and whether the stock is sold sooner or later. This consequence inheres in the nature of stock as a financial symbol representing an aliquot interest in corporate capital and surplus.

"For present purposes, however, we need not consider whether there is much or little to be said for the respondent's grievance. The short answer is that his complaint is irrelevant. The consequences which trouble the respondent 'are inherent under the statute as now framed.' They scarcely justify his efforts to persuade the courts 'to distort facts or to disregard legislative intent.' Boehm v. Commissioner, [326 U.S. 287, 295 (1945)]. The respondent's argument is properly addressed to Congress. 'We do not pause to consider,' Mr. Justice Cardozo wrote, 'whether a statute differently conceived and framed would yield results more consonant with fairness and reason. We take the statute as we find it.' Anderson v. Wilson, 289 U.S. 20, 27 (1933).

* * *

". . . The Supreme Court's . . . response in United States v. Nunnally Investment Co., 316 U.S. 258 (1942), is still more appropriate here. In the words of Mr. Justice Frankfurter, 'such a determination of policy in the administration of the income tax law should be made by Congress, which maintains a Joint Committee on Internal Revenue Taxation charged with the duty of investigating the operation of the federal revenue laws and recommending such legislation as may be deemed desirable.' Congress alone 'can deal with the matter comprehensively, unembarrassed by the limitations of a litigation involving only one phase of a complex problem.' Id. at 264. See also Helvering v. Gowran, [302 U.S. 238, 241-43 (1937)]. . . . . We cannot say more of the taxpayer's predicament than Mr. Justice Jackson's penetrating analysis in the Griffiths case. [Helvering v. Griffiths, 318 U.S. 371 (1943).] 'If he consulted the decisions' of the Supreme Court and other courts, 'he learned that no such tax could be imposed.' If he read the relevant statutes 'in connection with existing decisions,' they also 'assured him there was no intent to tax.' If he carefully 'followed

> the Congressional proceedings and debates, his understanding of nontaxability would be confirmed.' Finally, 'if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government.' 318 U.S. at 402."

The Court of Appeals for the Sixth Circuit, in reversing the Tax Court, accepted the above reasoning and concluded: 9/

> ". . . The facts in this case show tax avoidance, and it is so conceded by petitioner. But they also show a series of legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be. Unless we are to adopt the broad policy of holding taxable any series of transactions, the purpose and result of which is the avoidance of taxes which would otherwise accrue if handled in a different way, regardless of the legality and realities of the component parts, the tax assessed by the Commissioner was successfully avoided in the present case. We do not construe the controlling decisions as having adopted that view." (Citations omitted.)

Granite and Day, supra, the decisions of the Courts of Appeals for the First and Third Circuits cited in our opening brief (Appellant's Brief 11-12), are rooted in the fundamental principles time after time honored by the above

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9/ Chamberlin v. Commissioner, supra, 207 F.2d at 471-472.

line of authorities. The Commissioner attempts to distinguish those cases in the same unreasoned and ill-conceived way that the Tax Court in Gray attempted to distinguish Beard, Hobby, and Tully. He says that, in Granite and Day, "the courts found that the transfer of the stock and, thus, the transactions were real." Appellee's Brief 45.

The conflict between the decision below and the decisions of the First and Third Circuits in Granite and Day cannot be so disposed of. That conflict is one of law. The question presented in all three cases is the same: Where shareholders sell stock instead of liquidating their corporation, is the sale respected for income tax purposes? The question posed is one of basic income tax policy.

The Commissioner's attempt to treat the issue as one of fact is clearly refuted by Granite. The taxpayer in that case, a trust company, was the principal tenant of a building owned by a subsidiary corporation. The trust company, wishing to own the building directly, decided to purchase the building from the subsidiary. The trust company had a loss on its investment in the subsidiary, which could not be recognized upon liquidation of the subsidiary[10/] but could be recognized by sale of all or

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10/ Recognition of the loss on liquidation of the subsidiary was proscribed by section 112(b)(6) of the Internal Revenue Code of 1939, the antecedent of section 332 of the Internal Revenue Code of 1954.

a sufficient part of the stock of the subsidiary. Accordingly, on advice of counsel, the trust company sold a portion of the stock of the subsidiary, which was, shortly thereafter, liquidated.

The District Court sustained the Commissioner's disallowance of the loss on the following grounds:

> ". . . The purchasers bought their respective shares only as a favor to plaintiff. At the end of twelve days the 'purchasers' got their money back with a small profit. . . .
>
> "A taxpayer has the legal right to decrease the amount of what would otherwise be his taxes, or even avoid them altogether by means which the law permits. Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596. Substance, however, not form, controls, and the realities of a transaction must be examined in order to determine whether it is a mere formality without substance which may be disregarded for tax purposes. Higgins v. Smith, 308 U.S. 473, 60 S.Ct. 355, 84 L.Ed. 406; Bazley v. Commissioner, 331 U.S. 737, 67 S.Ct. 1489, 91 L.Ed. 1782.
>
> "None of the steps taken by the taxpayer would have been taken except as parts of a general scheme to liquidate the Building Corporation in such manner as to achieve a tax reduction." Granite Trust Company v. United States, 150 F. Supp. 276, 279-280 (D. Mass. 1955), rev'd, 238 F.2d 670 (1st Cir. 1956).

On appeal the United States made the arguments that the Commissioner makes on this appeal, and the trust company conceded that the sales of stock had been tax-motivated. Reversing the District Court and allowing the loss, the First Circuit said, in relevant part:

> ". . . Again and again the courts have pointed out that a 'purpose to minimize or avoid taxation is not an illicit motive.' Sawtell v. Commissioner, 1 Cir., 1936, 82 F.2d 221, 222. The Gregory case itself makes this clear, Gregory v. Helvering, supra, 293 U.S. at page 469, 55 S.Ct. at page 267. . . .
>
> ". . . We find no basis on which tc vitiate the purported sales, for the record is absolutely devoid of any evidence indicating an understanding by the parties to the transfers that any interest in the stock transferred was to be retained by the taxpayer. . . .
>
> ". . . In short, though the facts in this case show a tax avoidance, they also show legal transactions not fictitious or so lacking in substance as to be anything different from what they purported to be, and we believe they must be given effect in the administration of § 112(b)(6) as well as for all other purposes." 238 F.2d 670, 675, 677, 678.

The Third Circuit's decision in Day, supra, is to the same effect. The taxpayer corporation in that case owned 97 percent and 87 percent, respectively, of the voting stock of two ailing corporations which were in receivership and the assets of which had been wholly or substantially reduced to cash. On advice of counsel and for the admitted purpose of obtaining tax use of its losses on its investments in the ailing corporations, the taxpayer auctioned off enough of the voting stock to bring its ownership down to 78 percent and 75 percent, respectively. The purchaser at the auction was the taxpayer's treasurer. The Commissioner disallowed the losses on the ground that the sales of stock should be disregarded.

The Tax Court decided the case for the taxpayer on grounds that made it unnecessary for it to consider the Commissioner's argument that the sales should be disregarded. Day & Zimmerman, Inc. 3 CCH T.C. Memo. 760, 765, 768 (1944), aff'd on other grounds, 151 F.2d 517 (3d Cir. 1945). On appeal by the Commissioner, the Third Circuit found it necessary to face the question that the Tax Court had avoided. The Third Circuit rejected the Commissioner's request that it remand the case to the Tax Court for findings as to whether the taxpayer owned 80 percent of the two subsidiaries at the time of their liquidation. 151 F.2d at 519. Noting the Commissioner's argument that the sale of stock served no business purpose and was tax-motivated, the Third Circuit observed that, as the Supreme Court held in the Gregory case, "lawful fair efforts to minimize taxes are entirely permissible." Ibid. Whether or not the Tax Court recognized the sale, added the Third Circuit, "the facts before us so manifestly point to the legitimacy of the Katz purchase of stock that they offer no alternative but to accept that view of the transaction. It follows necessarily that the taxpayer was not the holder of 80% of the preferred stock of either Victor or Red Star in 1940, the year it suffered its losses." Ibid.

Faced with multiple adverse authorities spanning one-third of a century, and able to point only to the Tax Court's own recent opinions below and in two other cases as

favorable precedent, the Commissioner strays afield and cites two decisions that involve parties other than sellers of stock. [11/] Appellee's Brief 41-45. Those cases are clearly inapposite.

Because the Tax Court concluded in this case that "[e]ven though a transaction is put in the form of a sale, if it in fact results in an effective liquidation, it will be given such recognition," [12/] and thus failed to recognize that Congress intended to allow stockholders to choose freely between sale of stock or liquidation of their corporation, its decision should be reversed. "Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate." United States v. Cumberland Public Service Co., 338 U.S. 451, 456 (1950).

11/ Lowndes v. United States, 384 F.2d 635 (4th Cir. 1967); Blueberry Land Company, Inc. v. Commissioner, 361 F.2d 93 (5th Cir. 1965).

12/ 64 T.C. at 100.

III

The Commissioner's argument that one-half of the earnings and profits of Ininco should be attributed to Weiskopf is confused and unsound.

The Tax Court attributed one-half of the earnings and profits of Ininco to Weiskopf, although Weiskopf's interest therein was limited to a fixed dividend on preferred stock during 1964, 1965, and a portion of 1966, because Weiskopf exchanged part of his preferred stock for common stock in 1966 and section 1223 applied to that exchange. The Tax Court said that Treas. Reg. § 1.1248-1(a)(1) authorizes that result. 64 T.C. at 103. The Commissioner, in his brief, repeats that mistaken assertion and advances confused and unsound arguments in support thereof. Appellee's Brief 48-52.

To reveal the Commissioner's errors, we shall consider the provisions of Treas. Reg. § 1.1248-1(a)(1) and the proper role of section 1223 as applied to stock in controlled foreign corporations.

A. Treas. Reg. § 1.1248-1(a)(1) and the proper role of section 1223.

Treas. Reg. § 1.1248-1(a)(1) provides that a shareholder's gain upon the sale of stock of a controlled foreign

corporation shall be subjected to section 1248 treatment "to the extent of the earnings and profits of such corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, whichever is applicable, which were accumulated in taxable years of such corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered as held by reason of the application of section 1223) by such person while such corporation was a controlled foreign corporation."

Treas. Reg. § 1.1248-1(a)(1) thus requires a number of successive stages of attribution in order to bring the earnings and profits of a given year to bear upon the shares sold by a particular shareholder. As Treas. Reg. §§ 1.1248-2 and 1.1248-3 confirm, those stages are, in order, as follows: (1) ascertaining the earnings and profits for the entire taxable year; (2) if there is more than one class of stock, allocating such total earnings and profits among the various classes of stock in accordance with the earnings and profits that would be distributed to each class if all such earnings and profits were distributed on the last day of the taxable year; (3) allocating the earnings and profits of each class of stock among the outstanding shares of stock of such class on a daily basis (thus accounting for any variation throughout the year in the number of shares outstanding);

and (4) allocating to the selling shareholder as many of the foregoing equal daily amounts of earnings and profits, for each share of each class of stock sold by him, as correspond to the number of days within the taxable year during which two conditions are met: first, on that day the corporation was a controlled foreign corporation; second, on that day the stockholder held (or was considered to have held by reason of section 1223) that share of stock.

The foregoing demonstrates that computations under section 1248 are based upon the actual earnings and profits of the foreign corporation, the actual classes of stock outstanding, and the actual number of shares of each such class of stock outstanding. It is not the function of section 1223 to create hypothetical earnings and profits, hypothetical classes of stock outstanding, or hypothetical outstanding shares of any class of stock. On the contrary, the function of section 1223 in this context is to preserve the accrued consequences of section 1248 through gifts or tax-free exchanges for eventual recognition upon a taxable disposition of controlled foreign corporation stock. Section 1223 achieves that purpose by identifying the shareholder who must answer for the amount of earnings and profits assigned to a particular share of a particular class that was in fact outstanding on a particular day of the taxable year in question. Treas. Reg. §§ 1.1248-2(e)(2)

and 1.1248-3(c)(1)(ii). In that manner, the actual earnings and profits of the foreign corporation are fully accounted for and assigned among the shareholders, and, regardless of changes in stock ownership or capital structure, the accrued consequences of section 1248 are preserved.

For example, if one taxpayer transfers stock to another by gift, the second taxpayer will be considered to have held the stock during the time that it was held by the first taxpayer. The daily per share earnings and profits of the newly acquired stock will be attributed to the second taxpayer for the days during which the second taxpayer is deemed to have held the stock. The earnings and profits attributable to the stock will adhere to that stock in the hands of its new owner.

As a further example, if a taxpayer receives a new class of stock for old stock in a tax-free exchange, he will be considered to have held the new stock on each of the days that he held the old stock. The earnings and profits attributable to the old stock will shift to the new stock, as in the first example, but not as a result of attributing to the stockholder the daily per share earnings and profits of the newly-acquired stock for the days during which the stockholder is deemed to have held such stock. (During those days, the newly-acquired stock was not in fact outstanding; attribution

of such hypothetical earnings and profits would increase or diminish, not necessarily preserve, section 1248 consequences.) Instead, in accordance with Treas. Reg. 1.1248-3(c)(4), before establishing daily per share earnings and profits for each day during which stock is held or considered to be held under section 1223, earnings and profits are allocated among classes of stock. As a result, the daily per share earnings and profits of the newly-acquired stock for the days during which the old stock was outstanding is established by reference to the interest of the old stock in earnings and profits, and the daily per share earnings and profits of the newly-acquired stock for the days during which it was outstanding is established by reference to the interest of the new stock in earnings and profits.

B. The Commissioner's errors.

With the above background, we turn now to the Commissioner's errors:

(1) The Commissioner erroneously treated Weiskopf's contingent option to acquire common stock as the equivalent of outstanding common stock. Appellee's Brief 49. Weiskopf's option was exercisable only upon the happening of specified

events. Those events were not certain to take place during the decedent's lifetime. The Commissioner does not challenge the Tax Court's findings that Weiskopf's option was exercisable "only during his lifetime." 64 T.C. at 82.

A contingent right to acquire common stock is clearly not the equivalent of ownership of common stock. The views of the Supreme Court in a landmark tax case as to the status of a holder of warrants carrying the right to subscribe to stock of a corporation are clearly apposite: "[A] warrant holder . . . is not a shareholder . . . . His rights are wholly contractual . . . . [H]e 'does not become a stockholder by his contract in equity any more than at law.'" Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 200-201 (1942).

Moreover, the Commissioner's attempt to introduce constructive ownership notions into the application of section 1248 without benefit of statute conflicts with the Congressional policy of limiting constructive ownership rules to those provisions of the Code to which they are expressly made applicable. Section 318, for example, applies only "[f]or purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable." Congress, when it desired to do so, has provided for the treatment of options to acquire stock of foreign corporations as the equivalent of

outstanding stock. Section 554(b) so provides, for certain limited purposes, with respect to the stock of foreign personal holding companies. Section 958(b) so provides, for the limited purposes of establishing controlled foreign corporation status or the presence of foreign base company income, with respect to foreign corporations.

Section 1248, by contrast, does not involve constructive ownership rules of any sort; its application is based, and is clearly intended to be based, solely on actual ownership of stock.

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(2) The Commissioner may not, as he insists (Appellee's Brief 49-50), allocate to Weiskopf the earnings and profits that would have been allocated to him if he had in fact held his common stock since the inception. The correct application of section 1223 in this case requires allocation to Weiskopf's common stock, for each day since the inception of Intapco during which the common stock is considered as held by Weiskopf but during which the preferred stock exchanged therefor (and not the common stock) was in fact outstanding, the daily per share earnings and profits attributable to such preferred stock actually outstanding. The daily per share earnings and profits attributable to common stock is attributable to Weiskopf only for

the single day in 1966 that his common stock was in fact outstanding.

The Commissioner failed to heed the mandate of section 1248 and, as the Tax Court did, breached without any attempt at justification the basic federal tax principle of annual accounting that militates against retroactive adjustments of tax consequences on the basis of events that take place after the close of the taxable year.

(3) The Commissioner erroneously supposes that earnings and profits attributable to Weiskopf's preferred stock are not tacked on to the common stock received by Weiskopf in 1966. Appellee's Brief 50. On the contrary, such tacking is required by the Congressional mandate to take the full extent of earnings and profits of a controlled foreign corporation into account, and by the Treasury Regulations under section 1248, which implement that mandate.

(4) There is no inconsistency, as the Commissioner believes (Appellee's Brief 51), in the examples of the functions of section 1223 given in our opening brief. In each case, the result is the same: the accrued consequences under section 1248 are preserved unchanged for eventual recognition in a taxable transaction.

(5) The Commissioner's allegations that such examples are irrelevant and unsupportive (Appellee's Brief 51) are unexplained and may be traceable to his misunderstanding of the function of section 1223 as applied to stock of controlled foreign corporations.

(6) The Commissioner's allegation that such examples are economically unreal (Appellee's Brief 51) is based on the remarkably naive assumption that corporate stock never sells for more than book value. On the contrary, corporate stock may sell at prices either dramatically in excess of, or substantially below, book value.

(7) The burden of proof rule of section 1248(g) is plainly intended to protect the integrity of section 1248, not, as the Commissioner erroneously supposes (Appellee's Brief 52), to define its scope.

The scope of section 1248 is established by section 1248(a), which makes the statute applicable only "to the extent of the earnings and profits of the foreign corporation." It is to those earnings and profits, nothing more or less, that Congress addressed the mechanism of section 1248.

(8) H. H. Robertson Co., 59 T.C. 53 (1972), aff'd per curiam (3d Cir. July 24, 1974), cited by the Commissioner as an example of a double tax on earnings and profits (Appellee's Brief 52), holds that a dividend by a foreign subsidiary to its domestic parent of appreciated property reduces the earnings and profits of the subsidiary only by the amount of the subsidiary's adjusted basis in such property, even though the amount of the dividend taxable to the parent is equal to the full appreciated value of the property. Because the appreciation in such cases is not realized by the subsidiary and does not enter into its earnings and profits account (section 311 so commands, with exceptions not here material), however, there is of course no double tax on earnings and profits.

(9) Professor Nesson's article, cited by the Commissioner (Appellee's Brief 51), deals with earnings and profits problems that arise in the context of corporate divisons and liquidations and are of no concern here. The Commissioner fails to notice that Congress had no difficulty in subjecting the actual earnings and profits account of a continuing foreign corporation to section 1248 treatment upon changes in stock ownership.

(10) Contrary to the Commissioner's complaint (Appellee's Brief 52), it is entirely appropriate to limit Weiskopf's ordinary income tax under section 1248 because of his ownership of preferred stock. Section 1248 clearly contemplates that earnings and profits attributable to a shareholder will not be productive of tax at ordinary income rates to the extent that such earnings and profits exceed such shareholder's gain upon sale of stock of the controlled foreign corporation. Section 1248 clearly also contemplates the converse, that any such gain in excess of the earnings and profits attributable to the shareholder will not be subject to section 1248 treatment.

The Commissioner is apparently dissatisfied with those limitations, and would reallocate earnings and profits among the shareholders in accordance with their varying amounts of gain in order to maximize the aggregate impact of section 1248 in a given case. However, section 1248 applies on a shareholder-by-shareholder basis; it proscribes the Commissioner's revenue-oriented aggregate approach.

There is no unfairness in alerting the Commissioner that any expansion of his writ lies with Congress.

CONCLUSION

For the reasons stated above and in our opening brief, the decision of the Tax Court should be reversed.

Dated: New York, New York
March 22, 1976

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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ESTATE OF EDWIN C. WEISKOPF, Deceased, ANNE K. WEISKOPF and SOLOMON LITT, Executors, and ANNE K. WEISKOPF, Surviving Wife,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

AFFIDAVIT OF SERVICE BY MAIL

- -x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

The undersigned being duly sworn, deposes and says: Deponent is not a party to the action, is over 18 years of age and resides at 500 East 77th Street, New York, New York, 10021.

That on the 22nd day of March, 1976, deponent served four copies of the annexed reply brief on Scott P. Crampton, attorney for the Commissioner of Internal Revenue in this action at:

Scott P. Crampton, Esq.
Assistant Attorney General
Tax Division
Department of Justice
10th Street & Constitution Avenue
Washington, D.C. 20530

the address designated by said attorney for that purpose by depositing four true copies of same enclosed in a postpaid properly addressed wrapper, in - a post office - official depository under the exclusive care and custody of the United States Post Office Department within the State of New York.

That on the 22nd day of March, 1976, deponent served two copies of the annexed reply brief on Laurence Goldfein, attorney for Edwin C. Whitehead and Josephine Whitehead, at:

Laurence Goldfein, Esq.
Roberts & Holland
1301 Avenue of the Americas
New York, New York 10019

the address designated by said attorney for that purpose by depositing two true copies of same enclosed in a postpaid properly addressed wrapper, in - a post office - official depository under the exclusive care and custody of the United States Post Office Department within the State of New York.

Robert Thornton Smith
ROBERT THORNTON SMITH

Sworn to before me this
22nd day of March, 1976.

Joyce S. Flederman
Notary Public

JOYCE S. FLEDERMAN
Notary Public, State of New York
No. 31-6331440
Qualified in New York County
Commission Expires March 30, 1978